FRANCIS JOSEPH HESSER 110 INDUSTRIAL PARK DRIVE N. DEMOPOLIS, AL 36732-6221,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 05-225
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Francis Joseph Hesser ("Taxpayer") for State lodgings tax for January 2001 through July 2004. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on May 24, 2005. Ralston Long and Roy McBryar represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUES

The issues in this case are:

(1) Is the Taxpayer personally liable for the lodgings tax in issue;

(2) If the Taxpayer is personally liable, did the Department correctly estimate the amount of tax due;

(3) Was the Taxpayer denied due process because the Department failed to serve the preliminary assessment on him as required by Alabama law; and,

(4) Was the fraud penalty properly applied?

FACTS

The Taxpayer operated the Outback Motel and Apartments ("Outback" or "motel") in Demopolis, Alabama during the period in issue. The motel had eight apartments, ten single rooms, and ten double rooms.

The Department audited the Outback and several other motels in the Demopolis area and discovered that the Outback had never filed lodgings tax returns with the Department, as required by Code of Ala. 1975, §40-26-3. A Department examiner called on the Taxpayer at the Outback, which is located at 110 Industrial Park Drive N., Demopolis, Alabama. She requested records from which his lodgings tax liability could be determined. The Taxpayer responded that the motel was owned by a tax-exempt "pure trust," the Riverside Trust, and that the trust was not required to keep records or pay tax. The Taxpayer also showed the examiner a few index cards that contained a customer's name and the room rate charged. The examiner indicated that she wanted to review the cards when she returned to continue her audit. However, the Taxpayer told the examiner when she returned that he had thrown the cards away, and that he was closing the motel and leaving the country.[1]

The examiner discovered during her audit that the Taxpayer had deeded the land on which the motel is located to the Riverside Trust in 1997. The motel was constructed sometime between 1997 and 2001. The Department's records indicate that neither the Riverside Trust nor the Taxpayer, personally, have ever filed any type of tax return with the Department. The examiner also discovered that the Taxpayer had obtained annual business licenses for the motel from the City of Demopolis during the years in issue. The Taxpayer was listed as the contact person.

Because the Taxpayer failed to maintain any records, the examiner estimated that the motel had a 50 percent occupancy rate during the audit period. The examiner

[1] The Taxpayer made the statement to the examiner in mid-2004. The Taxpayer was still operating the business in May 2005.

testified that other motels she had audited in the area had occupancy rates of approximately 60 percent. The examiner then applied the monthly rates the Taxpayer charged at the motel to determine the motel's total receipts. The receipts were then multiplied by the 4 percent lodgings tax rate to determine the tax due. The Department also assessed the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d).

The Taxpayer makes four arguments on appeal.[2] First, he argues that he is not liable for the lodgings tax in issue because the Riverside Trust owns the motel, and that he only operated the motel as an independent contractor. In support of that claim, the Taxpayer's representatives submitted an agreement between the Trust and the Taxpayer whereby the Taxpayer agreed to operate the motel as an independent contractor. The agreement also indicated, however, that the Taxpayer would be responsible for all taxes due.

The Taxpayer next claims that the examiner's computation of the lodgings tax due is arbitrary and excessive. One of the Taxpayer's representatives, Roy McBryar, is a CPA. He testified that he used the motel's bank deposit records to determine that the motel's gross receipts during the audit period totaled $58,789.35. He multiplied the deposits by the applicable 4 percent tax rate to arrive at total tax due of $2,351.59 during the period. The Taxpayer claims that the $2,351.59 figure more reasonably reflects the lodgings tax due than does the $20,468 assessed by the Department.

The Taxpayer next contends that the Department failed to properly serve the preliminary assessment on him pursuant to Alabama law. He argues that the

[2] The Taxpayer failed to appear and testify at the May 24 hearing.

Department incorrectly mailed the preliminary assessment to the street address of the motel, not to his personal mailing address.

Finally, the Taxpayer asserts that the fraud penalty does not apply because he did not file false or fraudulent returns with the intent to evade tax.

ANALYSIS

Issue (1). Is the Taxpayer personally liable?

The Taxpayer claims he is not personally liable for the lodgings tax in issue because the motel is owned by the tax-exempt Riverside Trust, and that he only operated the business as an independent contractor for the Trust. I disagree.

The federal courts have on numerous occasions held that a "pure trust" of the type involved in this case is a sham and will not be recognized for tax purposes. See generally, *Higgins v. Smith*, 308 U.S. 473, 477 (1940); *Uri v. Commissioner*, 949 F.2d 371, 374 (10th Cir. 1991); *Zmuda v. Commissioner*, 731 F.2d 1417, 1420-1421 (9th Cir. 1984; *Markosian v. Commissioner*, 73 T.C. 1235, 1241 (1980); *Christal v. Commissioner*, T.C. Memo 1998-255.

The Taxpayer transferred the property on which the motel is located to the Riverside Trust in 1997. There is no evidence, however, that the Trust constructed or owns the motel building, that it receives the proceeds of the business, or that it is otherwise a viable entity that has economic substance.

In *Alsop v. Commissioner*, T.C. Memo 1999-122, the taxpayer attempted to avoid federal income tax by transferring the ownership and assets of his chiropractic business into two trusts. The Tax Court held that the trusts were shams, and that the taxpayer was personally liable for tax on the income generated by the business.

> As a fundamental principle of Federal income tax law, income is taxed to the person who earns the income. See *United States v. Basve*, 410 U.S. 441, 450 (1973); *Commissioner v. Culbertson*, 337 U.S. 733, 739-740 (1949); *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930); *Homan v. United States*, 728 F.2d 462, 464 (10th Cir. 1984); *Leavell v. Commissioner*, 104 T.C. 140, 148 (1995).
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> The tax laws do not recognize sham transactions or transactions that contradict economic reality. See *Higgins v. Smith*, 308 U.S. 473, 477 (1940); *Uri v. Commissioner*, 949 F.2d 371, 374 (10th Cir. 1994), affg. T.C. Memo. 1989-58. Where the establishment of trusts has no real economic effect, the substance of the transactions involving the trust will control over the form. See *Zmuda v. Commissioner*, 731 F.2d 1417, 1420-1421 (9th Cir. 1984), affg. 79 T.C. 714, 719 (1982); *Markosian v. Commissioner,* 73 T.C. 1235, 141 (1980)*; Christal v. Commissioner*, T.C. Memo. 1998-255.
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> This Court and the U.S. Courts of Appeals have long rejected attempts similar to Alsop's herein to avoid taxation by the use of abusive family trusts. See *Holman v. United States, supra*; *Hanson v. Commissioner*, 696 F.2d 1232 (9th Cir. 1983); affg. per curiam T.C. Memo. 1981-675; *Schulz v. Commissioner*, 686 F.2d 490 (7th Cir. 1982), affg. TC. Memo. 1980-568; *Vnuk v. Commissioner*, 621 F.2d 1318 (8th Cir. 1980), affg. T.C. Memo. 1979-164; *Vercio v. Commissioner*, 73 T.C. 1246 (1980); *Wesenberg v. Commissioner*, 69 T.C. 1005 (1978); *Buckmaster v. Commissioner*, T.C. Memo. 1997-236. Such trusts are treated as lacking in economic substance and as constituting a nullity for Federal income tax purposes. See *Hanson v. Commissioner, supra*; *Markosian v. Commissioner, supra*; *Wenz v. Commissioner*, T.C. Memo. 1995-277.
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> Attempts by chiropractors, in particular, who have sought to avoid taxation on income relating to their chiropractic practices by assigning or attributing income from the practices to "family trusts" have been rejected. See *Sandvall v. Commissioner*, 898 F.2d 455 (5th Cir. 1990), affg. T.C. Memo. 1989-189; *Kelley v. Commissioner*, T.C. Memo. 1983-322.
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> Alsop argues that the trusts he established constitute valid business entities and that the gross receipts, expenses, and net profits relating to the chiropractic practice should be charged to the trusts. Respondent contends that the trusts constitute sham family trusts that lacked economic reality, that the trusts were used only for tax avoidance purposes, and that the agreed net profits of the trusts are chargeable to Alsop. We agree with the respondent.

Alsop, T.C. Memo 1999-172.

The above case involved sham family trusts, but the principles applied by the Tax Court are equally applicable to sham pure trusts. There is no evidence the trust in issue was created for any purpose other than tax avoidance. Consequently, it will not be recognized for Alabama tax purposes.

Alabama's lodgings tax is levied on any "person, firm, or corporation engaging in the business of renting or furnishing" rooms to the public. Code of Ala. 1975, §40-26-1(a). The evidence establishes that the Taxpayer operated the Outback Motel and Apartments and was in the business of renting rooms to the public during the audit period. The Department's assessment based on that finding is *prima facie* correct on appeal, and the burden was on the Taxpayer to prove otherwise. Code of Ala. 1975, §40-2A-7(b)(5)c. He failed to do so. Consequently, the Department correctly assessed the Taxpayer, personally, for the tax due.

Issue (2). Was the tax correctly computed?

The Taxpayer failed to provide the Department examiner with any records from which his lodgings tax liability could be determined. The examiner consequently estimated that the motel had a 50 percent occupancy rate during the audit period. She then applied the monthly rates charged by the Taxpayer to determine his total receipts, which she multiplied by the 4 percent tax rate to determine the tax due.

The burden was on the Taxpayer to keep adequate records from which his lodgings tax liability could be determined. Code of Ala. 1975, §40-2A-7(a)(1). Because the Taxpayer failed to maintain records, the Department was authorized to compute his liability using the best available information. Code of Ala. 1975, §40-2A-7(b)(1)a. A final assessment based on such information is *prima facie* correct, and, as indicated,

the burden was on the Taxpayer to prove that it is incorrect. The Taxpayer must not only show that the Department's calculations are wrong, he must also present evidence establishing his correct liability. *Hentges v. C.I.R.*, T.C. Memo 1998-244 (U.S. Tax Ct. 1998); *U.S. v. Conaway*, 11 F.3d 40 (5th Cir. 1993); *Jones v. CIR*, 903 F.2d 1301 (1990).

The CPA hired by the Taxpayer used the deposits into the motel's bank account in an attempt to show that the Department's calculations were incorrect. There is no evidence, however, that all of the motel's lodgings receipts were deposited into the account. Cash payments could have been converted to personal use, and some receipts could have been deposited into other accounts. Consequently, although the CPA's computations are technically correct based on the information he used, there is no evidence that the information used was complete, i.e., that the bank deposits constituted the motel's total receipts. Those computations thus cannot be accepted as correct in lieu of the Department examiner's reasonable estimate that the Outback had a 50 percent occupancy rate, especially considering that the other motels in the area had an average occupancy rate of approximately 60 percent. The examiner's computation of the Taxpayer's liability is affirmed.

Issue (3). Service of the preliminary assessment.

The Taxpayer next argues that the preliminary assessment was not properly served as required by Alabama law. I disagree.

Code of Ala. 1975, §40-2A-7(b)(3) requires that a preliminary assessment must be mailed by the Department to the taxpayer's last known address. The Alabama requirement that an assessment must be mailed to a last known address is modeled

after the federal requirement that a federal notice of deficiency must be mailed to a taxpayer's last known address. 26 U.S.C. §6212(b)(1). Consequently, federal authority should be followed in determining if the Department properly mailed the preliminary assessment to the Taxpayer. *Best v. State, Dept. of Revenue*, 417 So.2d 197 (Ala. Civ. App. 1981).

A mailing "is sufficient if it is mailed to the address where the Commissioner reasonably believes the taxpayer wished to be reached." *Green v. United States*, 437 F.Supp. 334, 337 (1977). The focus is "on the most current information which the Department possesses." *U.S. v. Bell*, 183 B.R. 650 (SD Fla. 1995). "The controlling test . . . is whether, in light of all the pertinent circumstances, the IRS acted reasonably in mailing the deficiency notice" to the address in question. *Crum v. C.I.R.*, 635 F.2d 895, 899 (1980).

The Department did not have a last known or any other address on file for the Taxpayer because he has never filed a lodgings tax return, income tax return, or any other return with the Department. The Riverside Trust also has never filed any type of return with the Department. The Department thus reasonably mailed the preliminary assessment to the motel's street address. That was the address shown on the examiner's audit report. The Taxpayer signed for the audit report, and never notified the examiner or the Department that the address shown on the report was incorrect.

In any case, even if the Department did not properly serve the preliminary assessment at the Taxpayer's last known address, Alabama's courts have held that if a taxpayer is allowed an opportunity to contest an assessment, any prior procedural defects are cured. "The due process requirement is satisfied if there is opportunity to

question the validity or amount of a tax either before the amount is determined or in subsequently proceedings for its collection and enforcement . . ." *Rabren v. Baxter*, 239 So.2d 206, 212 (Ala. Civ. App. 1970), citing 51 Am. Jur. Taxation §731 and §732. See also, *Jackson v. State of Alabama*, P. 04-796 (Admin. Law Div. 1/4/05); *Matthews v. State of Alabama*, Inc. 03-740 (Admin. Law Div. 10/29/03).

The Taxpayer had an opportunity to contest the final assessment pursuant to his appeal before the Administrative Law Division. The Taxpayer's claim that due process has been denied is rejected.

Issue (4). The fraud penalty.

Section 40-2A-11(d) levies a 50 percent penalty "[i]f any part of an underpayment of tax required to be shown on a return is due to fraud, . . ." The fraud penalty was previously addressed by the Administrative Law Division in *Arnold v. State of Alabama*, S. 03-1098 (Admin. Law. Div. 7/27/04), as follows:

> Code of Ala. 1975, §40-2A-11(d) levies a 50 percent penalty for any underpayment due to fraud. "Fraud" is given the same meaning as ascribed in the federal fraud provision, 26 U.S.C. §6663. Consequently, federal authority and case law should be followed in determining if the fraud penalty applies. *State Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala. Civ. App. 1994).
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> The Department is required to prove fraud by clear and convincing evidence. *Bradford v. C.I.R.*, 796 F.2d 303 (1986). "The burden is upon the commissioner to prove affirmatively by clear and convincing evidence actual and intentional wrongdoing on the part of the (taxpayer) with a specific intent to evade the tax." *Lee v. U.S.*, 466 F.2d 11, 14 (1972), citing *Eagle v. Commissioner of Internal Revenue*, 242 F.2d 635, 637 (5th Cir. 1957). The existence of fraud must be determined on a case by case basis, and from a review of the entire record. *Parks v. Commissioner*, 94 T.C. 654, 660 (1990). However, because fraud is rarely admitted, "the courts must generally rely on circumstantial evidence." *U.S. v. Walton*, 909 F.2d 915, 926 (6th Cir. 1990), citing *Traficant v. Commissioner*, 884 F.2d 258, 263 (6th Cir. 1989). Consequently, fraud may be established from "any conduct, the likely effect of which would be to mislead or

> conceal." *Walton*, 909 F.2d at 926, quoting *Spies v. United States*, 63 S.Ct. 364, 368 (1943). The failure to keep adequate records and the consistent underreporting of tax is strong evidence of fraud. *Wade v. C.I.R.*, 185 F.3d 876 (1999) ("There is no dispute (taxpayer) kept inadequate books and records, further suggesting fraud.").

Arnold at 7 – 8.

The Taxpayer in this case argues that the fraud penalty does not apply because he never willfully filed a false or fraudulent return. The Taxpayer cites Department Reg. 810-14-1-.32 in support of his claim. That regulation provides, in part, that the 50 percent fraud penalty applies if any person files a false or fraudulent return. However, the fraud penalty statute, §40-2A-11(d), does not limit the fraud penalty to only instances in which a taxpayer files a false or fraudulent return.

The 50 percent fraud penalty applies "[i]f any part of any underpayment of the tax required to be shown on a return is due to fraud." Section 40-2A-11(d). The filing of a false or fraudulent return is not required for the fraud penalty to apply. Rather, under the federal fraud statute, which is applicable for Alabama purposes, the failure to file a return is an indication of fraud, as is the failure to report over an extended period, the failure to provide the government with access to records, and the failure to keep books and records. See, *Solomon v. Comm. of Internal Revenue*, 732 F.2d 1459 (6th Cir. 1984); see also, *U.S.A. v. Hahn*, 182 F.3d 919 ("Fraud is defined as an intent to avoid taxes; in finding fraud, the failure to file a return is a factor of particular weight. When coupled with other circumstantial evidence of fraud such as failure to keep adequate records . . ., the failure to file a return is persuasive evidence."); *Niedringhaus v. Comm. of Internal Revenue*, 99 T.C. 202, 213 ("While the mere failure to file tax returns may not be fraudulent (cite omitted), it can be evidence of the intent to evade tax.").

In this case, the Taxpayer not only failed to file lodgings tax returns, he also failed to maintain records, or, at the least, failed to allow the Department access to his records. During the examiner's initial visit to the motel, she observed some index cards showing the names of the Taxpayer's customers and the rates charged. However, when the examiner returned to review the records, the Taxpayer told her that they had been destroyed. Destroying relevant tax records during an audit is clear evidence of an intent to hinder the audit, and thus evade the tax due.

The most blatant indicia of fraud is the fact that the Taxpayer established a sham trust for the purpose of avoiding his tax liabilities. As discussed, the federal courts have repeatedly rejected such trusts as a fraudulent attempt to evade tax. Reg. 810-14-1-.32(3) also provides that the fraud penalty may be imposed if "the taxpayer devises a fictitious scheme to evade taxes . . ." The Taxpayer clearly did so in this case. There is no evidence that the Riverside Trust was an economically viable entity, or that it was created for any purpose other than to evade tax. The fraud penalty was thus correctly assessed.

The final assessment is affirmed. Judgment is entered against the Taxpayer for State lodgings tax, penalty, and interest of $32,847.40. Additional interest is also due from the date the final assessment was entered, December 28, 2004.

This Final Order may be appealed to circuit court within 30 days from the date of this Order pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered August 17, 2005.

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BILL THOMPSON
Chief Administrative Law Judge

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